

DOCKET SECTION

BEFORE THE  
POSTAL RATE COMMISSION  
WASHINGTON, D. C. 20268-0001

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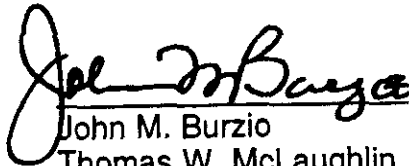
POSTAL RATE AND FEE CHANGES, 1997

Docket No. R97-1

INTERROGATORIES OF ADVO, INC. TO UNITED PARCEL  
SERVICE WITNESS J. STEPHEN HENDERSON (ADVO/UPS-T3-1-6)

Pursuant to sections 25 and 26 of the Rules of Practice, Advo, Inc. (Advo) directs the following interrogatories to United Parcel Service witness J. Stephen Henderson with respect to UPS-T-3.

Respectfully submitted,



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Thomas W. McLaughlin  
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CERTIFICATE OF SERVICE

I hereby certify that I have on this date served the foregoing document upon all participants of record in this proceeding in accordance with section 12 of the Rules of Practice.



Thomas W. McLaughlin

January 27, 1998

**ADVO INTERROGATORIES TO UPS WITNESS HENDERSON (UPS-T-3)**

**ADVO/UPS-T3-1.** On page 10, you state,

*...there is a good practical reason not to use incremental costs solely as a check against cross-subsidy. Without some markup over incremental cost, measurement error could lead to prices for some services that are below their actual incremental costs. . . .*

- (a) Please confirm that you do not propose just “some markup” over incremental cost, but a specific markup index that is related to historic markups that were applied to attributable costs that did not include incremental costs.
- (b) In your opinion, how much of a mark-up above incremental cost would be required in order to provide reasonable assurance that service prices are above their actual incremental costs (e.g., 5 percent, 20 percent, 100 percent)? Please explain your response.
- (c) Please explain why the Commission must “mark up” incremental costs in order to ensure that service prices are above their incremental costs.
- (d) Please explain why the Commission cannot account for both (1) possible measurement error and (2) incremental cost when it marks up volume-variable costs to generate a subclass price level?

**ADVO/UPS-T3-2.** Please confirm that a measurement error which understated incremental cost would not, alone, cause pricing below incremental cost. It would have to be combined with a service price level that was below the true value of incremental cost. If you cannot, please explain why not

**ADVO/UPS-T3-3.** Please refer to your discussion on the bottom of page 11 and top of page 12. In part, you state:

There is another sound economic reason to mark up incremental costs. The short-run marginal cost of providing postal services for a particular subclass of mail changes frequently as a result of changes in volumes, usage mixes, overtime rates, input costs, organizational changes . . . . Short-run marginal cost pricing may be appropriate if prices could change in a short time period, such as an hour, a day, a month, or a season. When prices do not change in this manner, however, the relevant cost basis for pricing decisions should correspond to the time period during which the rates will be in effect.

The postal rates that emerge from this case are likely to remain in place for two to four years. Accordingly, the relevant costs for pricing purposes are longer run, not short run, costs.... Unfortunately, the Postal Service's proposed rates are based solely on costs that vary over a much shorter time period.

... Therefore, the Postal Service's incremental cost estimates should be used as the basis for economically efficient markups.

- (a) If the USPS's rates were to remain in place for only one year (mid-1998 to mid-1999) and all USPS marginal costs were adjusted to recognize the changes in volumes, usage mixes, overtime rates, input costs, organizational changes, etc. for that time period, would you still recommend marking up incremental costs? Please explain.
- (b) If long-run marginal rather than short-run marginal costs were estimated in this case (and you were satisfied that they were correctly estimated and involved an acceptably small measurement error), would you still recommend marking up incremental costs? Please explain.
- (c) Are you suggesting that the USPS estimate of incremental cost is a proxy for long-run marginal cost? Please explain, including an explanation of the differences between incremental costs and long-run marginal costs.
- (d) Please explain your definition of the term "economically efficient."

ADVO/UPS-T3-4. On page 12, you state:

"... the relevant costs for pricing purposes are longer run, not short run, costs. Most (if not all) of the specific fixed costs identified by the Postal Service are avoidable in the time span between postal rate cases. . . . The longer-run incremental cost concept includes the longer run resource adjustments discussed above. Thus, long-run incremental cost (rather than the Postal Service's volume variable costs) is the appropriate basis for postal markups. While not perfect, the Postal Service's estimates of incremental costs are based on this concept."

When you use the term "long-run incremental cost," do you mean the full system costs that could be avoided, assuming longer-run resource adjustments, if a particular subclass were eliminated from the system? If not, please explain your meaning.

ADVO/UPS-T3-5. With respect to your statement on page 12, USPS witness Takis admits that he does not estimate the incremental costs that could be identified if

remaining operations within the Postal Service are "re-optimized" or "reconfigured" as a result of eliminating a particular class or subclass (USPS-T-41, page 10). He assumes that the postal system does not change as a result of elimination of an entire class or subclass because such a reconfiguration could alter service characteristics. However, assume that if First Class Mail were eliminated, the postal system could be reconfigured to eliminate additional costs beyond those estimated by Takis. Under this assumption, would incremental cost estimates that ignore certain longer-run resource adjustments (*i.e.*, system reconfiguration) still be considered longer-run incremental costs? Please explain.

ADVO/UPS-T3-6. In Exhibit UPS-T-3B, you present a table showing the results by subclass of your pricing proposals. Please provide a table in the same format showing the results by subclass assuming the rates proposed by the Postal Service.